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Home > Businesses > Help & Resources > Legal Library > Directives > Directives - By Decade > (2000-2009) Directives >

Directive 01-4: Application of Directives 99-4 and 99-5 to Letter Ruling 99-17 Type Reorganizations

INTRODUCTION:

In Letter Ruling 99-17 the Department ruled on some of the state tax consequences that follow from a reorganization in which a federal S corporation reorganizes such that it (a) is classified for purposes of federal taxation as a qualified S corporation subsidiary ("QSUB") pursuant to Internal Revenue Code ("Code" or "IRC") § 1361(b)(3)(B), and (b) is wholly owned by a Massachusetts corporate trust. One purpose of this Directive is to address whether the qualified retirement plan contributions on behalf of a beneficiary-employee of a corporate trust classified as an S corporation for federal purposes are deductible. The Directive's other purpose is to discuss the tax treatment of fringe benefits health insurance premiums provided to a beneficiary of a corporate trust who is a "2-percent shareholder" of an S corporation for federal purposes.

ISSUE 1:

Does the result in Directive 99-4 apply to a corporate trust that is a federal S corporation, to its QSUB and to its shareholder/ beneficiaries that have reorganized pursuant to Letter Ruling 99-17?

DIRECTIVE 1:

Yes. General Laws chapter 62, § 2(d) (1) allows a deduction for employer contributions to a qualified retirement plan on behalf of a shareholder-employee of an S corporation with a QSUB. The result reached in Directive 99-4 continues to apply when the federal S corporation is a corporate trust for Massachusetts tax purposes.

ISSUE 2:

Does the result in Directive 99-5 apply to a corporate trust that is a federal S corporation, to its QSUB and to its shareholder/ beneficiaries that have reorganized pursuant to Letter Ruling 99-17?

DIRECTIVE 2:

Yes. Under G.L. c. 62, § 2(d)(1) a 2-percent shareholder-employee of an S corporation with a QSUB is entitled to the deduction under IRC §162(l) available for health insurance premiums paid on behalf of the shareholder and his or her spouse and dependents. The result reached in Directive 99-5 continues to apply when the federal S corporation is a corporate trust for Massachusetts tax purposes.

DISCUSSION:

Under Letter Ruling 99-17, if a corporation is classified for federal tax purposes as a QSUB of a federal S corporation and for Massachusetts tax purposes as a wholly owned subsidiary of a corporate trust, the subsidiary's items of income, gain, loss, deduction and credit will be combined with those of the corporate trust and taxed together under G.L. c. 62, § 8. See DD 00-9.

Directive 99-4 – Deductibility of S Corporation Qualified Retirement Plan Contributions by Shareholder – Employees.

A corporate trust not falling under paragraph (b) of § 8 is taxed on its Massachusetts adjusted gross income as determined under c. 62, § 2. G.L. c. 62, § 8. Section 2(d) of c. 62 contains the deductions allowed in arriving at Massachusetts adjusted gross income. Subparagraph (1) of that section allows a deduction for employer contributions to or under a stock bonus, pension, profit-sharing or annuity plan or a deferred compensation plan deductible under § 404 of the Internal Revenue Code, but subparagraph (1)(D) disallows this deduction for contributions on behalf of IRC § 401(c)(1) employees. Directive 99-4 concludes that the deduction for employer contributions on behalf of shareholder-employees of an S corporation is allowed because they are not IRC § 401(c)(1) employees. Beneficiaries of the corporate trust who are employees of the trust or the QSUB are not IRC § 401(c)(1) employees because they are shareholder-employees of a federal S corporation. Therefore, in arriving at Massachusetts adjusted gross income, the corporate trust is allowed a deduction for IRC § 404 contributions on their behalf. Directive 99-4 and Letter Ruling 99-17.

Directive 99-5 – 2-Percent S Corporation Shareholders Treatment of Fringe Benefits Health Insurance Premiums

For federal tax purposes, an S corporation (including its QSUB) is treated as a partnership with respect to fringe benefits and its 2-percent shareholder employees are treated as partners with respect to such benefits. IRC § 1372(a). The value of fringe benefits provided to a partner is generally treated as a guaranteed payment (or payment to a non-partner) includible in the gross income of the partner and deductible by the partnership as an ordinary and necessary business expense. Rev. Rul. 91-26; 1991-1 C.B. 184; IRC §§ 61(a) and 162(a). Similarly, the value of fringe benefits, in this case the payment of health insurance premiums, on behalf of a 2-percent S corporation shareholder, his or her spouse, and dependents is includible in the gross income of the shareholder and deductible by the S corporation as an ordinary and necessary business expense. *Id.* A portion of the amount includible in the shareholder's income is then deductible under IRC § 162(l). For tax years 1999 through 2001 the amount of the federal deduction is 60% of the premiums. For 2002, the amount of the deduction is 70%; for 2003 and thereafter the deduction is 100% of the premiums. IRC § 162(l).

For Massachusetts tax purposes, in a Letter Ruling 99-17 type reorganization, the items of income, gain, loss, deduction and credit of the corporate trust and its QSUB will be combined and taxed together under G.L. c. 62, § 8. Under § 8, a corporate trust is taxed on its adjusted gross income as determined under G.L. c. 62, § 2. Subsection (d)(1) of that section allows a deduction for items deductible under IRC § 62, including ordinary and necessary business expenses deductible under § 162(a). Therefore, in arriving at Massachusetts adjusted gross income, the corporate trust is allowed the same deduction as above for health insurance premiums paid on behalf of its 2-percent shareholder/beneficiaries and their spouses and dependents. Directive 99-5 and Letter Ruling 99-17.

At the shareholder level, the payment of health insurance premiums of a 2-percent shareholder/beneficiary, his or her spouse and dependents is included in the federal gross income of the shareholder/beneficiary. Rev. Rul. 91-26; 1991-1 C.B. 184 and Directive 99-5. Massachusetts gross income is federal gross income with certain modifications not relevant here. G. L. c. 62, § 2(a). Therefore, these payments are included in the Massachusetts gross income of these shareholder/beneficiaries.

Under c. 62, § 2(d)(1), individuals are allowed a deduction for IRC § 62 deductions, which include the I.R.C. § 162(l) deduction for the payment of health insurance premiums on behalf of IRC § 401(c)(1) employees, their spouses and dependents. For purposes of this deduction 2-percent shareholder/beneficiaries are *deemed to be* IRC § 401(c)(1) employees. They are therefore entitled to this deduction for Massachusetts tax purposes. Directive 99-5. Because under c. 62 Massachusetts adopts the January 1, 1998 Code, the Massachusetts deduction is limited to 45% of the health insurance premiums for tax years 1999 through 2002, 50% for 2003, 60% for 2004, 70% for 2005 and 80% for 2006 and thereafter. TIR 99-23.

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Acting Commissioner Of Revenue

DD 01-4

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